**Office of Chief Counsel**
**Internal Revenue Service**

# memorandum

CC:NER:NJD:NEW:TL-N-8324-98
AAmmirato
date: July 9, 1999
to: Chief, Examination Division, New Jersey District
from: District Counsel, New Jersey District, Newark

subject: [redacted]

U.I.L.#7701.01-01
This responds to your request for advice on whether [redacted] constitutes a partnership for U.S. income tax purposes after it was converted to an unlimited company. We have also explored the potential tax consequences to [redacted] due to the change of [redacted] from a limited to an unlimited company under [redacted] law.

DISCLOSURE STATEMENT

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**FACTS:**

This advisory is based on the facts as provided in the following documents:

1) [redacted] Financial Statement for the year ended June 30, [redacted]; 2) Share Sale Agreement - An agreement for the purchase of [redacted] stock entered into between the "consortium members"[1], the

[1] [redacted], [redacted], [redacted] and [redacted].

State of [redacted] and the [redacted]; 3) Form 926, Return by a U.S. Transferor of Property to a Foreign Partnership, filed by [redacted]; 4) Consortium Agreement entered into by the "consortium members"; 5) Articles of Association of [redacted]; 6) Notice of General Meeting of [redacted], dated [redacted] (noting the change of the company from a limited to an unlimited company); 7) Operating Agreement, dated [redacted], entered into by the consortium members; 8) By-Laws of [redacted]; 9)Certificate of Incorporation of [redacted]; 10) Asset Sale Agreement - entered into between [redacted] (seller) and [redacted] (buyer); and 11) Asset Purchase Agreement - entered into between [redacted] (seller) and [redacted] (buyer).

In [redacted], the [redacted] state of [redacted] announced plans to deregulate the [redacted] supply industry which had been operated as a monopoly and protected by regulatory and institutional barriers. The assets and activities of the [redacted] were divided into [redacted] regionally based distribution companies. Three of the distribution companies serve metropolitan [redacted] and [redacted] serve rural [redacted]. The three companies serving the urban areas are [redacted], [redacted] and [redacted] ("[redacted]"). The government offered for sale by tender the shares and assets of the companies.

On [redacted], [redacted] under the laws of Delaware, formed [redacted], a [redacted]% owned subsidiary (dual resident corporation). [redacted] and [redacted] entered into an agreement with [redacted] ([redacted]) and its wholly owned subsidiary, [redacted] (both [redacted] companies), to purchase all of the outstanding shares of [redacted]. The parties entered into a formal "Consortium Agreement", which: i)described the initial and subsequent funding of the final bid; ii) outlined the decision making procedures for [redacted]; and iii) described the objectives of the Consortium Members and their relationship with each other and [redacted].

On [redacted], the acquisition bid was accepted and the shares were sold to [redacted] and [redacted]. [redacted], through [redacted] and [redacted], through [redacted], each acquired a [redacted]% interest in [redacted]. Pursuant to the Share Sale Agreement, the acquisition of [redacted] was accomplished through the following transactions:

1. [redacted] sold its plant and equipment to [redacted]

[redacted], an [redacted] company, for $[redacted], payment for the assets to consist of a note.

2. [redacted] revalued its licenses to $[redacted].

3. [redacted] declared a dividend of $[redacted] from the asset revaluation reserve payable to the [redacted] government, its shareholder. The dividend consisted of [redacted] L series redeemable preference shares and $[redacted] ordinary shares with a par value of $[redacted] each.

4. [redacted] subscribed for [redacted] SP Series Redeemable Preference shares For $[redacted] with the subscription price being a receivable owing to the company.

5. Out of the [redacted] account, [redacted] declared another dividend of $[redacted] to the [redacted] government in the form of [redacted] SEC Series redeemable preference shares.

6. The [redacted] government sold its ordinary shares and L Series redeemable preference shares to the Consortium for $[redacted].

7. [redacted] then bought back its plant and equipment from [redacted] with a note for $[redacted].

8. [redacted] redeemed the [redacted] SEC Series redeemable preference shares from the [redacted] government with a note for $[redacted].

Pursuant to provision [redacted] of the [redacted] Share Sale Agreement, the Consortium Group ensured to the [redacted] Government that the company would have available sufficient funds to repay and would procure the company to repay certain specified obligations of [redacted].

On [redacted], a special resolution was passed by the [redacted] converting the company from a limited to an unlimited company under [redacted]. The Financial Statement for [redacted] for the year ended June 30, [redacted] provides that the conversion to an unlimited company was effective as of [redacted].

**ISSUE:**

1) Whether [redacted] qualified as a partnership for U.S. federal income tax purposes after it was converted to an unlimited company?

**Conclusion**: Yes. The effective date of the change of [redacted] to a

partnership is [redacted].

**Law**:

The Treasury Regulations provide criteria for determining whether an entity is classified as a partnership, trust, estate or corporation for U.S. tax purposes. Treas. Reg. 301.7701-2 through 301.7701-4.[2] The regulations list six factors which ordinarily distinguish corporations from other organizations for federal tax purposes: 1) associates; 2) an objective to carry on a business and divide the gains therefrom; 3)limited liability for owners; 4)free transferability of interests 5) continuity of life; and 6) centralization of management. Treas. Reg. 301.7701-2(a)(1). An unincorporated organization shall not be classified as a corporation unless such organization or entity has more corporate than non-corporate characteristics. Treas. Reg. 301.7701-2(a)(3). In distinguishing between corporations and partnerships, the regulations disregard the first two characteristics since they are common to both partnerships and corporations. Treas. Reg. 301.7701-2(a)(2); 301.7701-2(a)(3). Therefore, the focus is placed on the last four factors. Id. An organization which lacks free transferability of interests and limited liability is classified as a partnership for U.S. income tax purposes. Rev. Rul. 88-8, 1988-1 C.B. 477.

The classification of a foreign business organization for federal tax purposes is also determined under Section 7701. Id. However, the local law of the foreign jurisdiction and the organization's agreements must be examined in determining the legal relationships of the members of the organization among themselves and with the public at large, as well as the interests of the members of the organization in its assets. Rev. Rul. 93-4, 1993-3 I.R.B; Rev. Rul. 88-8, 1988-1 C.B. 403. All foreign entities are considered to be unincorporated organizations for purpose of Treas. Reg. 301.7701-2(a)(3). Rev. Rul. 88-8, 1988-1 C.B. 403. Therefore, no foreign organization is classified as a corporation unless it has more corporate than non-corporate characteristics. Id.

**Analysis**:

In determining whether [redacted] is a partnership for U.S. income tax purposes, the Articles of Association and the Consortium Agreement were referenced since both documents govern

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[2]These regulations are no longer applicable for entity classification beginning in 1997. The new "check the box" regulations are effective as of January 1, 1997.

[redacted].[3]

1. Limited Liability. An entity has limited liability if under local law no member is personally liable for the debts of, or claims against, the entity. Treas. Reg. 301.7701-2(d)(1). Limited or unlimited liability may result from local law or from the articles of organization of the entity. See Rev. Rul. 93-4, 1993-3 I.R.B.; Rev. Rul. 88-8, 1988-1 C.B. 403. If the organizational documents provide that a particular member is not personally liable for the debts of the entity, the regulations presume that personal liability does not exist unless it is shown that the provision is ineffective under local law. Treas. Reg. 301.7701-2(d)(2).

[redacted] Financial Statements for the year ended June 30, [redacted] and the Notice of General Meeting of [redacted] on [redacted], provide that [redacted] was converted to an unlimited liability company in accordance with [redacted] of the Corporations Law of [redacted]. Under [redacted] law, an unlimited company is a company formed on the principles of having no limit placed on the liability of its members. See, [redacted] Corporate Law [redacted] and [redacted]. Therefore, [redacted] possesses the non-corporate characteristic of unlimited liability.

2. Free Transferability of Interests. An entity has free transferability of interests if each of its members, or at least each of those owning substantially all of the interests, has the power, without the consent of the other members, to substitute for itself in the same entity a person that is not a member of the entity. Treas. Reg. 301.7701-2(e)(1). Free transferability does not exist if the organizational documents prohibit any transfer or any transfer without the consent of the other members. See Treas. Reg. 301.7701-2(e)(1), Ex.7; Rev. Rul. 88-8, 1988-1 C.B. 403. In general, an entity lacks free transferability of interests if, throughout the life of the entity, the organizational documents expressly restrict the transferability of the entity interests representing more than 20% of all interests in the capital, income, gain, loss, deduction and credit of the entity. Rev. Proc. 92-33, 1992-1 C.B. 782. Where a member may transfer an interest in an entity only after offering it to the other members at fair market value, the regulations treat such as a modified form of free transferability. Treas.

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[3] [redacted] of the Consortium Agreement provides that to the extent of any inconsistencies between the Articles of Association and the Consortium Agreement, the Consortium Agreement controls with the exception of Articles [redacted] and [redacted] of the Articles of Association.

Reg. 301.7701-2(e)(2). The modified right counts as a corporate factor. See Treas. Reg. 301.7701-2(g), Exs. 4, 5, 6.

To determine whether [redacted] possesses "free transferability of interests", we must examine how the "interests" in the capital of the company are divided and the restrictions placed on the transfer of such "interests". Based on the examination of the Articles of Association of [redacted] and the Consortium Agreement it does not appear that the interests in [redacted] are freely transferable.

The Articles of Association, Article [redacted] (Capital and Shares) provides:

> The share capital of the Company is $[redacted] divided into [redacted] shares of $[redacted] each of which [redacted] shares are classified as follows:
> (a) [redacted] Class A ordinary shares;
> (b) [redacted] Class B ordinary shares;
> (c) [redacted] Class C preference shares; and
> (d) [redacted] Class D preference shares.

Article [redacted] provides that the A and C shares are subject to the transfer restrictions (Article [redacted]).

Article [redacted] (Transfer of Shares) Provides, in part:

> [redacted]. Subject to these Articles, a member may transfer the shares held by that member.
>
> [redacted]. All transfers of A and C shares are subject to the following restrictions:
>
> (a) subject to paragraphs (b) and (c), a member which is the holder of class "A" or "C" shares may only transfer all or any of those shares so held where:
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> (i) The transferring member gives notice in writing to all other members, setting out the number and class or classes of subject shares which the transferring member proposes to transfer, the name and address of the proposed transferee and the number and class or classes of transferring Shares to be transferred to each such transferee; and
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> (ii) each of the members other than the transferring Member consents in writing, which consent may be given or withheld by any of the other members (unreasonable or otherwise) in each other member's absolute discretion.

(b) paragraph (a) does not restrict the transfer of Class "A" shares or "C" Shares from one member to another member...; and

(c) if paragraph (a) is, by rule or operation of any law or any principle of equity, interpreted so as to require that consent to a transfer of class "A" or "C" shares can only be withheld in circumstances where the withholding is reasonable, paragraph (a) has no force or effect, is deemed never to have any force or effect, and transfers of class "A" and "C" shares are absolutely prohibited except in accordance with paragraph (b).

Article [redacted] provides that any purported transfer of A Shares or C shares otherwise than in accordance with Article [redacted] will be null and void and will have no effect whatever.

Article [redacted] provides that the directors:

(a) Must refuse to register any transfer of shares which is, or which they consider to be, in breach of any of the articles.

(b) May in their absolute discretion and without assigning any reason decline to register any transfer of shares or other securities.

Based on the above, it is apparent that because of the restrictions placed on their transferability, the A and C class shares of [redacted] are not "freely transferable" under the regulations. Furthermore, it also appears that the other classes of shares of [redacted] are also not "freely transferable" due to the discretion granted to the directors under Article [redacted] on whether or not to register a transfer of shares.

Clause [redacted] of the Consortium Agreement provides:

(a) during the period of two years from the "completion date" no consortium member may sell or transfer legal or beneficial interest in its shares without prior approval of the Government and in accordance with clause [redacted] or without the prior written consent of the other members.

(b) at any time after the second anniversary of the completion date no consortium member may sell or transfer

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[4]Clause [redacted] provides that the transferor must first offer the shares to the other members prior to selling to a third party.

legal or beneficial interest in its shares other than in accordance with clause [redacted] or without the prior written consent of the other consortium members.

Clause [redacted], of the Consortium Agreement effectively extends the restrictions placed on the transferability of the Class A and C shares to all the classes of shares.[5] Based on the terms of the Articles of Association and the Consortium Agreement, interests in [redacted] can not be transferred without the prior approval of the other member(s). Therefore, pursuant to Treas. Reg. 301.7701-2(e)(1), [redacted] lacks the corporate characteristic of free transferability of interests.

The [redacted] members have unlimited liability and the interests in [redacted] are not freely transferable. Therefore, it is a partnership for U.S. tax purposes. See Rev. Rul. 88-8, 1988-1 C.B. 477 (A company that lacks the corporate characteristics of free transferability of interest and limited liability is classified as a partnership). Although we can end our analysis at this point, we will examine whether [redacted] possesses the other two corporate characteristics.

3) Continuity of Life. An entity has continuity of life if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will not dissolve the entity. Treas. Reg. 701.3301-2(b)(1). "Dissolution" means "an alteration of the identity of an organization by reason of change in the relationship between its members as determined under local law." Treas. Reg. 301.7701-2(b)(2). In determining whether an entity has continuity of life, the regulations consider both the organizational documents and their effect under local law. Treas. Reg. 301.7701-2(b)(3). If a dissolution occurs under local law upon the withdrawal of a member there is no continuity of life regardless if the organizational documents provide that the remaining members will continue the business. Id. An entity can avoid continuity of life by providing in its organizational documents that the entity can be terminated by the will of any member. Id. Continuity of life may also be avoided by a provision in the documents providing that bankruptcy of any owner will

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[5]Clause [redacted] of the Consortium Agreement provides that to the extent of any inconsistencies between the terms of the Consortium Agreement and the Articles of Association, the Consortium Agreement controls, with the exception of Articles [redacted] and [redacted] of the Articles of Association. Therefore, clause [redacted] supercedes Article [redacted] of the Articles of Association which provides that the shares of [redacted] (other than class A and C) are freely transferable.

cause dissolution. Rev. Rul. 93-4, 1993-3.

[redacted] law provides that all companies (limited and unlimited) may be wound up either through court order or voluntarily by the members or creditors. See [redacted] Corporations Law, Part [redacted], Chapter [redacted]. The members can only wind up the company through a special resolution. Id. Therefore, as an unlimited company, the bankruptcy, withdrawal or expulsion of a member would not result in the dissolution of [redacted]. Furthermore, the Articles of Association and the Consortium Agreement do not contain any provisions providing that the entity can be terminated by the will of any member. It appears that [redacted] possesses the corporate characteristic of continuity of life.

4) Centralization of Management. An entity has centralized management if any person "has continuing exclusive authority to make management decisions necessary to the conduct of the business for which the organization was formed". Treas. Reg. 301.7701-2(c)(1). Such persons who are vested with such management authority resemble the directors of a statutory corporation. Id. Centralization of management does not exist unless the managers have sole authority to make management decisions without the ratification of the members. Treas. reg. 301.7701-2(c)(3),(4). For example, no centralized management exists where any partner within the scope of the partnership business binds all the partners. Id. Furthermore, centralization does not exist if all members make decisions by majority vote. Treas. Reg. 301.7701-2(g).

The Articles of Association of [redacted] as well as the Consortium Agreement (See Articles [redacted] and [redacted] provides for a Board of Directors. Article [redacted] of the Consortium Agreement provides that the day to day control of [redacted] will be managed by a Chief Executive Officer who reports to the Board for [redacted] Activities and Operations. Since the operations of [redacted] are controlled by a Board of Directors which has the power to make decisions without the ratification of all the members, [redacted] possesses the corporate characteristic of centralized management.

**The effective date of the change of [redacted] to a partnership for U.S. Tax purposes.**

It is undisputed that prior to the change to an unlimited company, [redacted] was a corporation for U.S. income tax purposes. [redacted] possessed at least three of the four corporate characteristics (limited liability, centralized management and

continuity of life).[6] Therefore, when [redacted] changed from a limited to an unlimited company, a reorganization of [redacted] from a corporation to a partnership occurred for U.S. income tax purposes.

The change of [redacted] from a limited to an unlimited company marked its conversion to a partnership for U.S. tax purposes. Therefore, in order to determine when [redacted] converted to a partnership, we must ascertain when [redacted] changed to an unlimited company. The Minutes of the Meeting of the [redacted] Board held on [redacted] contains the resolution that [redacted] was changed to an unlimited company in accordance with section [redacted] of the [redacted] Corporate Law. However, the [redacted] Financial Statement for the period ending [redacted], provides that [redacted] was the effective date of [redacted] change from a limited to an unlimited company. The taxpayer argues that the change to an unlimited company occurred on [redacted]. The taxpayer alleges that [redacted] reflects the effective date for the change to an unlimited company under [redacted] law which provides for a 30 day waiting period prior to a change in entity classification. Since section 7701 does not contain such a 30 day waiting period, the taxpayer argues that the change was effective immediately for U.S. tax purposes when the resolution was passed on [redacted].

The classification of a foreign business organization for federal tax purposes is determined under Section 7701. However, the local law of the foreign jurisdiction must be applied in determining the legal relationships of the members the organization among themselves and with the public at large, as well as the interests of the members of the organization in its assets. Rev. Rul. 93-4, 1993-3 I.R.B. Under [redacted] law, a thirty day waiting period was required prior to [redacted] becoming an unlimited liability company. Therefore, it appears that [redacted] members continued to possess limited liability until [redacted]. As such, [redacted] did not convert to a partnership for U.S. tax purposes until [redacted].

**General discussion of potential tax consequences of change in entity status.**

This section will discuss the potential tax consequences

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[6]Based on the filing of Form 926 (Transfer of Property to a Foreign Partnership), it appears that the taxpayer concedes that there was a change in the entity classification of [redacted] for U.S. income tax purposes and the change occurred after [redacted] became an owner.

resulting from a change to partnership status. We did not perform a comprehensive analysis of the facts to determine whether [redacted] realized any taxable gain for U.S. tax purposes. This is a general discussion only and is not meant to provide a legal opinion as to the actual tax effect of the transactions involved.

When an entity changes from a corporation to partnership for U.S. income tax purposes, two transactions are deemed to occur: 1) the corporation is completely liquidated and its assets are distributed to its shareholders and 2) the shareholders are deemed to contribute the assets to the newly formed partnership in return for interests in the partnership. This section will discuss the potential tax consequences of the transactions on [redacted].

1) Potential tax consequences on the liquidation.

Amounts received by a shareholder in a distribution in complete liquidation of a corporation is treated as payment received in exchange for the corporate stock. I.R.C. Section 331(a). Under our facts, a complete liquidation of [redacted] occurred as a result of the change from a corporation to a Partnership for U.S. tax purposes. As a [redacted]% shareholder, [redacted] was deemed to receive [redacted]% of the underlying assets of [redacted] in return for its shares. Under section 1001(a), a gain/loss is computed by subtracting [redacted]'s adjusted basis in the [redacted] stock from the fair market value of the assets received. [redacted] purchased the [redacted] stock on [redacted] and the effective date of the distribution of the assets to [redacted] was [redacted] (date of the change to an unlimited company). Considering the proximity in time between the purchase of the [redacted] shares and the liquidation of [redacted], [redacted]'s adjusted basis in the shares probably equaled the assets' fair market value.[7] Therefore, it is unlikely that [redacted] realized a gain on the exchange.[8]

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[7]Conclusion is based on the assumption that the shares were purchased at fair market value which approximated the value of the company's assets.

[8]We did not perform a comprehensive analysis to determine the taxpayer's adjusted basis in its [redacted] shares and the fair market value of the assets at the time of liquidation. It appears that the documents may provide sufficient information to perform the analysis. The Share Sale Agreement, provision [redacted], provides the purchase price of the shares. In addition, provision [redacted] provides that the consortium members assured that certain liabilities of [redacted] would be satisfied. The assumption of

Under section 336(a) gain or loss is recognized to a liquidating corporation on the distribution of its assets in a complete liquidation as if such property were sold to the distributee at fair market value. However, with respect to a foreign corporation, no U.S. tax applies to the gain realized unless it is effectively connected to a U.S. trade or business under section 882(a)(1). [redacted] is an utility company supplying [redacted] to customers in [redacted]. [redacted] is not engaged in any U.S. trade or business, therefore the gain, if any, would not be subject to U.S. tax. Furthermore, since [redacted] sold and then repurchased its assets pursuant to the Asset Sale Agreement, its adjusted basis in its assets probably equaled their fair market value at the time of liquidation. Therefore, [redacted] would not have realized a gain on the distribution.

**i. Section 1248**

Since a liquidation of a foreign corporation under section 331 is treated as a sale/exchange, a gain, if any, on the transaction may be treated as a dividend under Section 1248. To be subject to section 1248, a "U.S. person" must own, or have owned, 10 percent or more of the voting stock of the foreign corporation at some time during the five-year period ending on the date of the sale or exchange. I.R.C. Section 1248(a)(2). The minimum stock ownership must have existed on a day that the corporation was a "controlled foreign corporation" under section 957. Id.

A "controlled foreign corporation" means any foreign corporation if, 1) more than 50 percent of the total combined voting power of all classes of stock entitled to vote and 2) more than 50 percent of the total value of the stock of such corporation is owned (within the meaning of section 958(a)), or is considered as owned by applying section 958(b), by "United States Shareholders" on any day during the taxable year of the foreign corporation. I.R.C. section 957(a). I.R.C. Section 958(b) provides for constructive ownership utilizing modified section 318 attribution rules (I.E. substitutes 10% for 50% under section 318(a)(2)(C)[attribution from corporations]). Section 958(a)(2) provides, in part, that stock owned directly or indirectly by a foreign corporation shall be considered as being owned proportionally by its shareholders. A "U.S. Shareholder" is a

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liabilities would increase [redacted]'s adjusted basis in the [redacted] shares. The Asset Sale Agreement between [redacted] and [redacted] can be referenced to assist in determining the fair market value of the assets.

U.S. person who owns (within the meaning of section 958(a)), or is considered as owning by applying section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation. I.R.C. Section 951(b).

In our facts, [redacted] owned [redacted]% of [redacted] while [redacted] was a foreign corporation. Pursuant to section 951(b), [redacted] qualified as "U.S. Shareholders". Next, it must be determined whether [redacted] qualified as a controlled foreign corporation. Since [redacted] only owned [redacted]% of the [redacted] shares (more than [redacted]% of vote and value is required)[9], it must be determined if [redacted] was also constructively owned, pursuant to section 958(a)(2) or 958(b), by "U.S. Shareholders". For instance, if "U.S. Shareholders" owned [redacted]% of the [redacted], then pursuant to section 958(a)(2), [redacted]% of [redacted] would have been owned by "U.S. Shareholders" and it would have qualified as a controlled foreign corporation pursuant to 958(b).[10] Since we were not provided with facts pertaining to the ownership of the [redacted], we are unable to determine whether [redacted] constituted a controlled foreign corporation.

In the event that [redacted] qualified as a controlled foreign corporation, it does not appear that [redacted] would be subject to taxation under 1248 for the following reasons: 1) Section 1248 does not apply to a short term gain. Section 1248(g)(2)(C). It is apparent that any gain realized by [redacted] on the exchange of the shares would have qualified as a short term gain. 2) It does not appear that [redacted] realized any gain on the exchange of the [redacted] stock. Therefore, section 1248 would have no application. See Treas. Reg. 1.1248-1(c).

**ii. Subpart F Income.**

Assuming that [redacted] qualified as a controlled foreign corporation, [redacted] may be subject to subpart F income. Under section 951(a), "if a corporation is a controlled foreign

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[9]Please note that it is possible that the [redacted]% interest owned by [redacted] constituted over [redacted]% of the vote and value of [redacted].

[10][redacted] indirectly owned through [redacted]% of the shares of [redacted]. Therefore, pursuant to section 958(a)(2), a [redacted]% ownership interest in [redacted] would result in a [redacted]% ownership interest in [redacted].

corporation for an uninterrupted period of 30 or more days during any taxable year, every person who is a 'U.S. shareholder' of such corporation and who owns (within the meaning of section 958(a)) stock in such corporation on the last day, in such year, on which such corporation is a controlled foreign corporation shall include in his gross income" his 'pro rata share' of the companies subpart F income during such year. [redacted] qualified as a controlled foreign corporation on [redacted] and ceased being a controlled foreign corporation on [redacted], the date of liquidation. The 30 day period of section 951(a) is determined by excluding the day on which the corporation became a controlled foreign corporation (ie. the day the stock was acquired). Treas. Regs. 1.951-1(a) and (f). Therefore, [redacted] was not a controlled foreign corporation for a 30 day period during [redacted] ([redacted] to [redacted] is only [redacted] days). However, even if [redacted] did meet the 30 day requirement, it is unclear whether it had any subpart F income. Subpart F income includes, in part, "foreign personal holding company income" as defined in section 954(c). Foreign personal holding company income includes dividends, interest, royalties, rents and annuities. Section 954(c)(1)(A). Foreign personal holding company income does not include active trade or business income. A "U.S. Shareholder" is not subject to a tax on a controlled foreign corporation's subpart F income if the sum of such income is less than the lesser of 5% of its gross income or $1,000,000. Section 954(b)(3)(A). [redacted] is engaged in an active business in [redacted] and the income from such business would not constitute subpart F income. However, it is possible that [redacted] earned other "passive" types of income during the taxable year which would be included under subpart F.

**ii. Tax Consequences of the transfer of the assets to the partnership**

A partnership and its partners generally do not recognize gain or loss on the contribution of property to a partnership. Treas. Reg. 1.721-1(a). However, special rules govern the transfer of property to a foreign partnership. I.R.C. Section 1491 imposed a 35% excise tax on the transfer of appreciated property to a foreign partnership by a U.S. resident, U.S. citizen, domestic corporation, domestic partnership, or non foreign estate or trust.[11] A U.S. taxpayer that transfers property to a foreign partnership must file on the day of the transfer a return on Form 926. Treas. Reg. 1491-1(a). A tax under Section 1491 applies to the excess of the fair market value of

[11]The section was repealed as of August 8, 1997.

the transferred property over the sum of 1) the adjusted basis of the transferred property, plus 2) any gain recognized by the transferor at the time of transfer. I.R.C. Section 1491. Pursuant to Section 1492, a taxpayer had the choice to elect to apply section 367 or section 1057 in lieu of section 1491. Section 1057 allows a taxpayer to elect to treat a Section 1491 transfer as a sale or exchange of the transferred property and to recognize a taxable gain. It was required that Form 926 be completed with the proper box checked noting that the taxpayer chose to apply section 1057 to the transaction.

In our facts, the taxpayer filed Form 926 and made an election to have section 1057 apply to the transaction. The taxpayer indicated that there was no gain on the transfer of the assets to the partnership since the adjusted basis in the underlying assets was equal to the assets fair market value. The taxpayer appears to be correct. Under section 334, the basis of the property received by the taxpayer as a result of the liquidation of [redacted] equals the assets fair market value. Since the contribution of the assets occurred immediately after the liquidation, there was no inherent gain in the assets to be realized on the transfer.

This advice is subject to National Office post review. If you have any questions contact attorney Anthony Ammirato at 973-645-2539.

MATTHEW MAGNONE
District Counsel

By: /s/
WILLIAM F. HALLEY
Assistant District Counsel

Noted: /s/
MATTHEW MAGNONE
District Counsel

cc: Edward Parker, Revenue Agent
cc: ARC-TL(NER)